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## KEYNES AND THE 2008-9 CRISIS KEYNES Y LA CRISIS DE 2008-9

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### Resumen

La actual crisis financiera desde finales de 2008 ha devuelto a la actualidad las propuestas de Keynes, incluida la propuesta de crear una moneda internacional (Bancor). El artículo reflexiona sobre algunas de estas medidas, la eficacia de las políticas monetarias, la creciente desigualdad de los ingresos, el nuevo papel de los bancos, las estrategias políticas de los gobiernos ante la crisis y las oportunidades para combinar la recuperación con medidas que favorezcan un desarrollo más sostenible.

### Abstract

Since late 2008, together with the current financial crisis we can see a return of the Keynes's proposals, including the proposal to create an international currency (Bancor). This paper reflects on some of these measures, the effectiveness of monetary policies, the growing income inequality, the new role of banks, political strategies of governments to address the crisis and the opportunities for combining the economical recovery with measures to promote a more sustainable development.

*“Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on the whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill done “*

JOHN MAYNARD KEYNES

It is being said by some that everyone in the current crisis is a Keynesian in believing that governments must spend their way out of a crisis rather than cutting back their spending. But it is not recognised that Keynes meant spending on job creation and especially on capital projects, not just bailing out the speculators. Others regard Keynes as just too *passe*. He was arguing for state spending when states still had power to act on their own. In a globalised world economy this is no longer possible. This is to underrate Keynes. He spent the whole of the last years of his life proposing the creation of international institutions –a world bank, an International Clearing Union, International Trade Organisation, even a world money - BANCOR to ensure that nation states acted together. The fact that his proposals for world financial institutions were taken over by the United States as instruments of American power, trade was left to a General Agreement on Tariffs and Trade (GATT), there was to be no Clearing Union and the US dollar became the world's currency, was not Keynes's intention at all. In the current financial crisis all Keynes's proposals are being resurrected. They had had an earlier rebirth in the recession of the early 1990s when, on the advice of Stuart Holland and Ken Coates in the European Parliament, the EU President Jacques Delors had proposed to stimulate European employment through a major European investment fund. It did not happen, but it was all written down by Stuart Holland in his **Towards a New Bretton Woods** published by Spokesman, 1994 (summarised in the chapter on Keynes in my **Models in Political Economy**, Penguin, 1995).

What is interesting is that the current revival of Keynes's proposal for an international money, BANCOR, is being proposed by the Chinese authorities, who up till now have been the main holders of their currency reserves in US dollars. Without these Chinese holdings the vast US foreign debt would be unmanageable and the US would lose the advantage of its financial dominance. It is hardly likely that the US will give up their position lightly or that the Chinese will wish to keep their funds in dollars for ever. The outcome is unpredictable, but it is noteworthy that the immediate response of the

European Financial Authorities was that any extension of the Special Drawings Rights invented by the International Monetary Fund in 1969 to provide a supplementary reserve currency for countries in difficulty with their balance of payments would be dangerously inflationary. The Chinese authorities had suggested that these Special Drawing Rights might become the basis for a revival of Keynes's idea of BANCOR as a world money.

The importance of this is that Keynes's fundamental recognition of the basic weakness of the capitalist money system is absolutely central to the present crisis. The argument is relatively simple, as it applied to the crisis of the 1930s but I have not seen it being rehearsed in all the articles and correspondence concerning the current crisis. It runs as follows: Keynes distinguished a consumption sequence in the market and an investment sequence. The first was determined by what he called "aggregate demand" for goods, the rate of consumers' decisions to spend. The second was determined by the rate of saving for investment, mostly by those richer people and companies with capital to invest in productive activities. During boom years the proportion of incomes going to saving rose, so that there were more savings available for investment, by which Keynes meant actual purchases of capital goods. For a time capital investment rose, but, if consumption did not rise in line with this new capacity to invest in producing goods, a crisis arose. Capital investment in production was suddenly stopped as surplus stocks built up. Those with capital looked for other uses for their capital.

Keynes argued that there was nothing in the market model to ensure that the balance between savings and consumption was equal to the balance between investment in capital goods and the production of consumption goods. It was supposed that the rate of interest on savings would act as a regulator of the balance. But, while a high rate of interest would encourage saving, it would discourage investment; and a low rate would discourage saving, but would not necessarily encourage investment. The last would depend upon the demand for production of consumer goods. In other words, the interest rate could pull activity down, acting like a piece of string, but string cannot push things up. Keynes never said that the savers were the richer members of any society and the consumers the poorer. That would have sounded too much like Marx's critique of Capital.

The chief doubt that Keynes had about the efficacy of lower interest rates was that when rates were low and there was little or no more demand for consumption, then most savers preferred liquidity, i.e. to hold on to their cash beyond what was needed for paying debts. This is where everything has changed since Keynes's day. He was thinking of a largely closed economy without

freedom of capital movements. The change is that economic globalisation means that controls on capital movements have been eliminated, so that holders of capital –persons and institutions including the banks who once preferred liquidity can move their funds wherever they can see a profitable move, which is frequently a speculative activity. A large proportion of the sale of derivatives takes place across international borders. The other element in globalisation is the reduction of regulation not only of capital movements but of risk taking in general. This is what enabled the banks to indulge in the provision of mortgages without adequate guarantees of repayment, resulting in the widespread housing crisis in the USA and the UK. Huge sums of money were earned by the speculators, while the incomes of the mass of the population stagnated. Keynes recognised that growing inequality of incomes was the basic cause of crisis. The poorer people could not consume so much; the richer could not find so much demand for their capital investment in production. In the absence of consumer demand for more goods, what the rich turned to was speculation, which he did not think was a good thing, as the epigraph to this article indicates.

Keynes had noticed that when slump replaced boom, the first and heaviest falls took place in the capital investment goods sector as aggregate demand in the market for consumption goods declined. He therefore recommended governments to spend more money on the production of capital goods –houses, schools, railways, roads, energy and other parts of an economy's infrastructure. He would certainly not have given state funds to the bankers who would not necessarily invest it in new production, whether of capital goods or consumer goods, thus creating new employment. He would have given it to local government authorities and regional authorities like the Tennessee Valley Authority in the USA, for providing public and social services and construction schemes, as Roosevelt did in following Keynesian measures in his New Deal legislation to get the US out of the 1930s slump, the last deep slump before the present one.

## INCOME INEQUALITY

Growing inequality of incomes was recognised by Professor J.K.Galbraith in his classic work, **The Great Crash 1929** as the fundamental cause of the 1930s slump. Between 1922 and 1930 profits in US manufacturing industry rose in real terms by 130%, while real earning rose by only 17%. Similar figures have been recorded for the US in the last decade, and the previous decade of the 1990s saw an actual fall in real wages while profits boomed. The British Government has claimed that inequality of incomes was actually redu-

ced after New Labour took power in 1997. There was a very small reduction up to 2002 in the difference, between the share of UK incomes of the top 20% and of the bottom 20%, but the gap widened again thereafter. The distribution of post-tax incomes between high, medium and low quintiles was almost exactly the same in 2007/8 as it had been ten years earlier when New Labour came to power; and this was after Mrs Thatcher and John Major had greatly widened the inequalities. The rich had continued to become richer, especially the top few per cent of incomes, and New Labour had done nothing to increase the taxes on the rich.

The UK was not, however, the only place where inequalities had increased. The widest gap had opened up in the United States, where profits had risen steadily while wages in real terms had hardly risen over two decades. In the 1990s similar gaps had opened up elsewhere especially in Latin America, but also in the areas of economic growth, most especially in China but in India also. The gap between rich and poor in Russia was unparalleled. Moreover, average incomes in the Developing Countries, as a whole but particularly in Africa, were falling behind those in the Developed. This was partly due to falling prices of primary commodities relative to those of finished manufacturers, when Developing Countries were still dependent on income from their commodity exports. But other reasons were even more important, associated with the privatisation of state assets.

Privatisation of public companies had begun by Pinochet in Chile, and under the Thatcher and Reagan governments in the UK and USA in the 1980s, but it became widespread in the 1990s. Russia provided the most extreme example, but the privatising process was taking place elsewhere in Europe, and most particularly in China and also in Latin America. Instead of raising taxes, which were unpopular, especially among the rich, governments were meeting the demands of public spending by selling off state assets. Two reasons were given for these sales. The first was that state enterprises were a drain on public resources. In fact, World Bank reports record that foreign borrowing was generally covering any deficits in public accounts in most Developing Countries; the second was that public enterprise was inefficient. This reason for privatisation has always been used, and still is adhered to quite religiously, by British Governments. The late lamented Andrew Glyn in his major work on British capitalism in 2006 argued that there was no evidence of improved efficiency, in productivity for example, after privatisation in the UK. Nor can the argument of harmful vested state interest stand up against similar arguments against crony capitalism. What is clear is that political pressures and not any economic rationale were driving privatisation, and

in Developing Countries the main pressure was coming from the IMF and the World Bank. The Neo-Liberal consensus had become universal, that the market should be left to allocate resources with minimal state regulation and maximum freedom for capital movements.

### THE CHANGED ROLE OF THE BANKS

This has led to a new role being taken by the banks. Instead of simply holding their customers' moneys and lending money out beyond the value of their holdings, at agreed rates of interest related to the official bank rate, in order to finance business activity, the banks had begun to conduct trading operations themselves. Much of this has been speculative, buying or borrowing company shares in order to sell them at a profit and lending money for mortgages without guarantees that the mortgage payments could be maintained. It was, as we have seen, the latter that led to the crisis in the USA and also in the UK. The bank's buying of shares, often in very large companies encouraging a great number of mergers and take-overs, also led to much risk taking of debt and ultimate bank failures. The development of hedge funds and private equity groups has been a particularly large element of what Peter Gowan in a brilliant editorial in *New Left Review* (no 55 Jan/Feb 2009, pp.5-29) calls "The New Wall Street System" and has led to the current financial crisis. Gowan makes it clear that the City of London has not just been an adjunct of Wall Street but a major player, boasting of the most unregulated market in the world and in 2007 having a global share of 42.5 % of derivatives (That is to say moneys whose value depends on the value something else, i.e. varying forms of credit.)

What then should be done with the banks, to start with the British banks? Just bailing them out hasn't worked and cannot be made to work with the banks' accumulated mass of mortgage and other debt. Money will have to be made available by government to help those in danger of dispossession of their homes, but not once more in the hands of the commercial banks. There is an obvious alternative, which would have popular support –the Post Office. Closing it down as was originally intended by Lord Mandelson, to have some of its functions replaced by the giant retail companies, was no solution. Mandelson has now apparently recognised that the Post Office Bank needs to be brought into action as an agent of public sector finance, starting with houses and going on to providing credit for small businesses. This must be a good move if the commercial banks can be left to return to their original role. Their shareholders and chief executives could then be made to suffer; it was they who got us into the mess we are in.

## NEXT STEPS

The international monetary authorities have rightly judged that the UK will have the greatest difficulty of all states in recovering from the current crisis, and this for three reasons. The first is the scale of the house mortgage debt; the second is the extent of British banks' involvement in hedging and trade in derivatives; the third is the failure of government fiscal policy, to build up a surplus in the good years to be available when things went bad. The first two can only be dealt with by abandoning the commercial banks so that they cannot repeat past errors and, as already suggested, by reactivating the Post Office Bank with heavy state support. The third problem of the government deficit can be overcome by taking ruthless steps to retrieve the vast sums that the rich have squirreled away in tax havens in British territories, chiefly the Isle of Man, the Channel Islands, Cayman Islands and the Bahamas. Before becoming Chancellor Gordon Brown promised to address this leaking of funds, but in fact it grew steadily year by year under his chancellorship, to a figure quoted even by the Government Department of Customs and Revenue as amounting to over £13 billion. Other estimates are much higher, at twice that figure.

What remains to be decided is how to spend the resources available to government so as to increase employment and offset the increasing loss of confidence in the British economy, and especially what not to spend money on. The first and most obvious step is to end the useless and dangerous military expenditure in pursuing the war in Afghanistan and replacing the Trident. But there is a positive alternative. A great window of opportunity opens up for combining recovery with essential steps to stave off the disastrous effects of our wasteful carbon emissions contributing greatly to what is euphemistically called "climate change". A massive programme of house insulation and adaptation needs to be launched, combined with projects for developing sources of energy from wind, solar and wave power. All such activities would be highly effective in generating new employment and business confidence. The agents for managing these programmes and their owners should be local and regional authorities and specially created and designated public bodies. The success of Roosevelt's Tennessee Valley Authority is already being recalled by President Obama.

Gordon Brown who has always loved to learn from United States practice could now begin to learn from a new President. If he and Alastair Darling fail to end the "New Wall Street System" in Britain and to set sail on a new course, it seems possible that the Tories might do it. Philip Blond, director of the Progressive Conservatism Project at the DEMOS think-tank, has already in an article in *Prospect* (February 2009, pp.32-36) proposed some of the

measures that have been suggested above including a revamped Post Office Bank. This may have been what persuaded Lord Mandelson to change his mind about the Post Office. What is for sure is that Mandelson and Brown have to be held to their promises. There must be a real ban on the rich salting their money away in tax havens, and the Post Office Bank must be given the resources to be the major agent of the Government's recovery programme. None of this will happen without a ground swell of support for alternative policies to end the bankers' ramp. Massive demonstrations in France and near civil war in Greece have begun to be echoed by the strike of construction and power workers in East Anglia with sympathy actions elsewhere especially in Wales and Scotland. At some point, anger will have to be turned into positive action, and no better starting point could be found in Britain than rescuing the Post Office and funnelling state support for economic recovery through the Post Office Bank.